

PRIVATIZATION IN DEVELOPING COUNTRIES: A SUMMARY ASSESSMENT

JOHN NELLIS

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Contents

FOREWORD

After 25 years of privatization worldwide, has the sale of state-owned enterprises to the private sector been welfare improving? What lessons have we learned from this vast experience so far? And what are the possible implications for the MENA region in general and Egypt in particular? These are the main questions addressed by John Nellis in this edition of the *Distinguished Lecture Series*.

Besides tracing the evolution of privatization over the last twenty five years across regions and sectors, Dr. Nellis summarizes the extensive evidence on the outcome of privatization up until now. The main conclusion of this survey is that the economic impact of privatization on the performance of privatized firms is positive in the majority of cases. However, the distribution of the benefits among different stakeholders has not always been even. The key determinants of success seem to be the extent to which governments adopt appropriate measures to enhance competition, establish effective regulation of monopolies, conduct the sale process in a transparent manner, and devise reasonable packages to compensate the losers.

The discussion that followed the lecture was very rich, covering such topics as the relationship between privatization and unemployment, the political economy of privatization, and the methods of sale. The answers by the speaker were no less profound. Both the lecture and summary of discussion are included in this publication.

Ahmed Galal
Executive Director and Director of Research, ECES
December, 2005

تقديم

بعد مرور ٢٥ عاما على مسيرة الخصخصة عالميا، ما هي الدروس المستفادة من هذه التجربة حتى الآن؟ وهل ساعد بيع المنشآت المملوكة للدولة للقطاع الخاص على تعزيز الرفاهة؟ وما هي دلالات هذه الخبرة بالنسبة لدول الشرق الأوسط بشكل عام ومصر بشكل خاص؟

يجيب د. جون نيليس في هذا العدد من سلسلة المحاضرات المتميزة عن هذه الأسئلة، وذلك من خلال إعادة قراءة الشواهد الدالة على محصلة هذه العملية وتطورها خلال الخمسة وعشرين عاما الماضية. ويخلص د. نيليس إلى نتيجة رئيسية مفادها أنه على الرغم من أن تأثير الخصخصة على أداء الشركات كان إيجابيا في أغلب الحالات، إلا أن توزيع المكاسب اختلف كثيرا من حالة إلى أخرى. وعليه، يرى أن نجاح الدول في تطبيق الخصخصة يتوقف على تبني الحكومة لسياسات من شأنها تعزيز المنافسة، ووضع إطار تنظيمي فعال للكيانات الاحتكارية، وإجراء عمليات البيع بأسلوب يتسم بالشفافية، وأخيرا تصميم آليات لتعويض الخاسرين.

وقد تطرقت المناقشة الثرية والمفيدة التي أعقبت هذه المحاضرة إلى العديد من الملاحظات والأسئلة المتعمقة من أهمها العلاقة بين الخصخصة والبطالة، واعتبارات الاقتصاد السياسي للخصخصة، وأساليب بيع المنشآت العامة. وجاءت إجابات د. نيليس عن استفسارات الحضور على نفس القدر من التعمق والوضوح. ويضم هذا الإصدار كل من المحاضرة وملخص المناقشات.

د. أحمد جلال

المدير التنفيذي، المركز المصري للدراسات الاقتصادية

ديسمبر ٢٠٠٥

ABOUT THE SPEAKER

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John Nellis is currently a non-resident senior fellow at the Center for Global Development, and a principal at International Analytics. Dr. Nellis is also a consultant on privatization and public sector reform for a number of organizations including the World Bank, the International Monetary Fund, the International Law Institute, and the G-17 Institute. From 1984-2000, he was a staff member at the World Bank, eventually reaching the position of director of the Private Sector Development Department.

Prior to his work at the World Bank, Dr. Nellis held research and teaching positions at the University of Nairobi, Carleton University in Ottawa, Canada, and the Maxwell School at Syracuse University. He served two years as the representative of the Ford Foundation in North Africa. Dr. Nellis has published extensively and authored a number of books and articles with a concentration on the effects of privatization. He earned his Ph.D. in Political Science from Syracuse University.

PART I

PRIVATIZATION IN DEVELOPING COUNTRIES: A SUMMARY ASSESSMENT*

I. INTRODUCTION

Almost 25 years have passed since Margaret Thatcher (along with some lesser-known pioneers) introduced, or reintroduced, privatization into economic affairs. In the ensuing quarter century, privatization—the divestiture, or transfer of ownership and/or operational control of productive economic entities to private owners, operators and investors—has swept the world. Perhaps as many as 100,000 firms and business units formerly owned and operated by governments, in every industrial, commercial and service sector, in every geographical region of the world, have undergone some form of the process. Guinea Bissau, Syria, Libya, Cuba, North Korea and perhaps Sudan[1] are among the few states that have not tried privatization—and even in these countries some thought is being devoted to the prospect.

There are many forms of privatization, ranging from the outright sale of government's entire stake, to partial sale, to concessions, leases, and management contracts, to the hiving off and sale of non-core business activities, to the opening of previously restricted sectors to new private entrants and competitors. Each one of these approaches has been carried out in a variety of ways.[2]

Despite its prevalence and popularity with finance ministers, the international financial institutions (IFIs), and many economists who have analyzed the subject, privatization is viewed with suspicion and alarm by the general public, especially in developing countries. The many

* Portions of this study draw on previous works of the author: World Bank (2003), Nellis (2003, 2005b), and World Bank (2005b). The author acknowledges the valuable comments and suggestions of Ms. Nilgün Gökgür.

[1] At least no privatizations are recorded for these countries in the World Bank's new privatization database 2005, which can be accessed at http://rru.worldbank.org/Privatization/

[2] The many forms of privatization are not dealt with in detail in this study. They are briefly described in the "Options for Privatization" section in Guislan and Kerf (1995, 1). The relationship between forms of privatization and outcomes is complex. For one survey of this issue in post-communist, transition economies see Djankov and Murrell 2002.

surveys touching on the subject reveal, across all regions of the developing world, a fluctuating but steady majority of voices opposed to the concept, or at least holding the view that privatization has not been beneficial. For example, the polling firm *Latinobarometro* annually surveys reactions to economic programs and policies among 19,000 people in 18 Latin American countries (with a combined population of more than 400 million). The percentage of respondents viewing privatization *negatively* rose from 55 percent in 2001 to 80 percent in 2003, and then fell back to about 70 percent in the 2005 poll.[3] Surveys from other regions, including sub-Saharan Africa, the post-communist transition states, and South Asia, also show high levels of public opposition (Kikeri and Kolo 2005, 22-24).

To the suspicion and hostility of the general public one must add the strident anti-privatization voices of most labor leaders, NGO activists and anti-globalization intellectuals, and many journalists, academics, politicians and more than a few maverick economists.[4] The policy has many opponents, and they are active and vocal.

We shall examine below the political economy of privatization and try to explain privatization's unpopularity. The immediate point is that because privatization has been the most contentious item in the liberalization agenda it has also been the most studied of reforms: There are evaluations of privatization's impact on a firm's financial and operational performance and returns to shareholders (Megginson and Netter 2001), its macroeconomic effects, (International Monetary Fund 2000), its consequences for economic welfare both in the aggregate and in terms of groups of the most affected actors in societies (Galal et al. 1994), and its social and distributional impact (Nellis and Birdsall 2005). In addition, there are dozens of case, sectoral, country and regional studies, and detailed analyses of just about every technical aspect of the issue.[5]

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[3] *Source*: *The Economist's* on-line reporting of *Latinobarometro* results, at: http://www.economist.com/World/la/displayStory.cfm?story_id=5093522

[4] And some not so maverick: Nobel Laureate Joseph Stiglitz, for example, has criticized the concept and practice of privatization in both developed and developing economies, as hastily conceived and poorly implemented.

[5] A handy bibliographical source on privatization is "papers and links" section in the privatization portion of the World Bank's Rapid Response Unit: http://rru.worldbank.org/PapersLinks/

However, all this analysis has not produced a settled body of opinion on the costs and benefits of the process. The debate over privatization's impact and utility continues to rage; and the number of polemical statements for and especially against privatization (e.g., Kahn and Minnich 2005) continues to mount. The purpose of this paper is to take stock of this process as it has been applied in developing and post-communist countries; to summarize, in a reasonably accessible manner, what is known, both pro and con, and what is not known about privatization in these parts of the world.

The approach is as follows. Section II presents reasons why privatization has been employed, and summarizes privatization's impact on a firm's financial and operational performance, the efficiency of resources employed, and returns to shareholders; that is, the microeconomic issues. Section II also reviews the broader fiscal, macroeconomic and welfare impacts of privatization. Section III looks at caveats to and concerns about the perceived impacts, noting the economic sectors (e.g., infrastructure) and geographical regions (e.g., low income areas and transition states) where the findings are less positive in favor of privatization. It then reviews the complex relationship between economic institutions and privatization processes and outcomes.

Section IV looks at privatization's impact on income distribution and poverty. Section V notes the surprisingly large amount and high value of assets that remain in the hands of states in many parts of the world, particularly in the Middle East and North Africa, and briefly reviews the MENA privatization experience. Section VI discusses the political economy of privatization, in particular, the "disconnect" between the generally positive technical/economist assessments and the public's hostility to privatization. Section VII concludes.

II. WHAT HAS HAPPENED?

Why Privatize?

Why did privatization rise (or, more accurately, return) to prominence?

The trend of the first three-quarters of the 20th century was state intervention in productive aspects of the economy, not withdrawal. From 1900-75 the world witnessed: the spread of the socialist ideology and then the imposition of communism in the Soviet Union (and later China and a number of other states); enormous social and economic burdens imposed by repeated, protracted and worldwide wars; the near-breakdown of the capitalist system during the great depression; and the post-WW II disintegration of European colonial empires and their replacement by regimes, few of which initially had ties to private economic actors. These factors led many governments, overtly socialist and otherwise, to adopt interventionist economic programs. A prime operational principle of these programs was the public ownership and management of productive entities, especially in infrastructure.

Throughout the first two-thirds of the century, these "public enterprises" grew in number, size and significance, accounting on worldwide average for over 10 percent of GDP by the 1970s. Average percentages in developing countries surpassed 15 percent, with much higher figures in overtly socialist and communist economies.

A number of public enterprises performed well—but not well enough. They generally failed to live up to the expectations of creators and financiers. Numerous studies and reports from the 1970s through the 1990s documented their shortcomings.[6] Rather than contribute to state budgets, public enterprises drained them. A high percentage failed to produce a sufficient quantity of or high quality service or product. Particularly troublesome was a widespread failure to charge cost-covering tariffs in infrastructure/utility public enterprises; subsidies from government and soft budgets kept them afloat. These flows eventually posed large financial burdens on government budgets—and attracted the attention of the IFIs and donors.

[6] A summation of the nature and causes of public enterprise performance problems was found in the World Bank's *Bureaucrats in Business* (1995).

The fundamental problem of public firms was multiple, ambiguous and conflicting objectives. To illustrate: government owners decreed that public enterprises operate in a commercial, efficient and profitable manner. At the same time they insisted that they finance their actions with debt rather than equity, provide goods and services at prices less than cost, generate employment, receive their inputs from state-sanctioned suppliers, choose plant location based on political rather than commercial criteria, hire their staff on the basis of who they knew rather than what they knew, and so on. The mixing of social and political with economic objectives weakened managerial autonomy, commercial performance, and efficiency.

Repeated efforts to solve these problems by means other than changing ownership produced good results in a few settings (e.g., Chile, Korea, Mexico, New Zealand), modest results in many (e.g., Egypt, the Philippines, Ghana), and little or none in far too many others.[7]

Even when results were positive, they tended not to last. It was repeatedly demonstrated that proper information and monitoring systems, incentives, and financial discipline could be introduced in public enterprises. But too often, as the precipitating financial crisis eased another more socio-political crisis replaced it. And as the dynamic reformers who had brought about the improvements moved on to other areas and interests, the capacity and will to impose painful reforms faded. Political interference resurfaced, poor performance reemerged, and the gains from reforming policies and leaders dissipated.

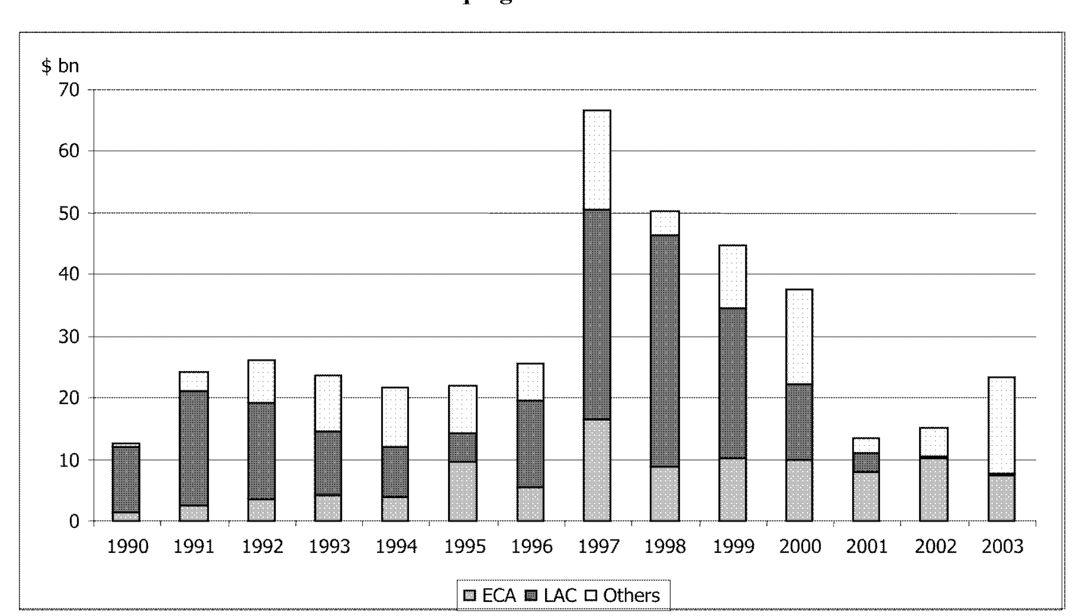
As disappointment with enterprise reform mounted, government and donor enthusiasm grew concerning privatization. In retrospect, this enthusiasm was generated as much or more by the modest results of performance improvement approaches other than divestiture, by the privatization examples of Britain and a few other OECD countries, and by expectations based on hope and theory, rather than on hard empirical evidence of the superiority of private

[7] For a review of public enterprise reforms other than privatization, see Shirley and Nellis 1991.

participation and ownership in non-industrial economies. Thus, the shift to privatization was something of a leap of faith—but it was carried out.[8]

Tables 1 through 4, below, indicate the scope of divestitures in developing and transition countries since 1990. In these regions total revenues from privatization topped $400 billion. The number is impressively large. Even so, the use of cash transactions and sales proceeds as indicators greatly underestimates the scope of privatization: recall that in transition countries, literally thousands of firms—15,000 in Russia; 4,500 in Mongolia alone—were divested for vouchers, meaning no revenues were raised by the seller. These privatizations are not accounted for in the tables.

Table 1. Privatization Proceeds: Developing and Transition Countries



Source: World Bank privatization database, compiled by Kikeri and Kolo 2005, 5.
Note: The complete database can be accessed at http://rru.worldbank.org/Privatization/

[8] This exercise will not show precisely how this was done.

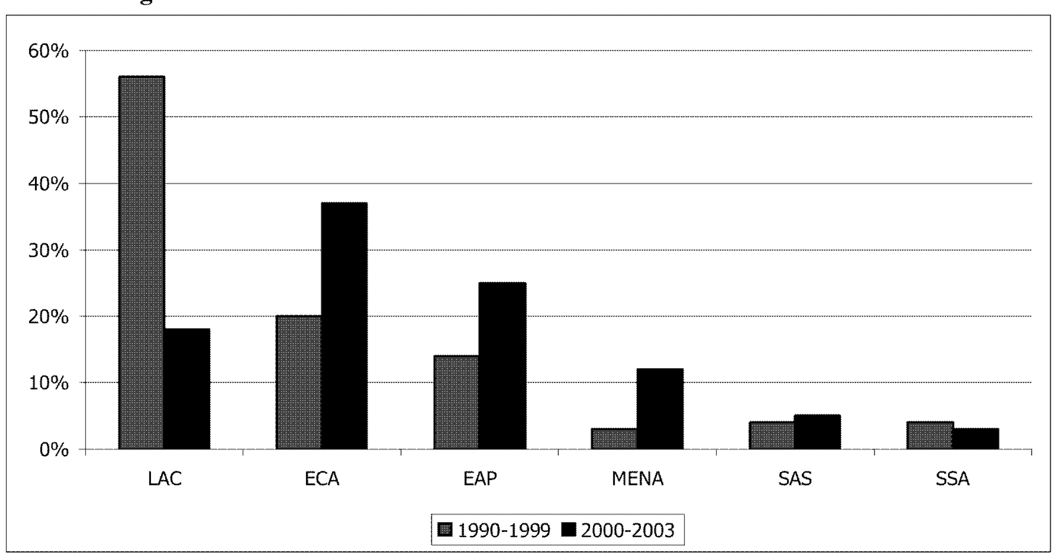
Table 2. Number of Transactions and Proceeds

1,200 | 1,000 | 800 | 600 | 400 | 200 | 0
70 | 60 | 50 | 40 | 30 | 20 | 10 | 0 USD Billions
1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003
Number of transactions — Total proceeds

Source: Kikeri and Kolo 2005, 6.

Note: Again, note that the transaction numbers refer to the firms sold for cash.

Table 3. Regional Distribution of Privatization Proceeds: 1990-99 and 2000-03



Source: World Bank 2005a.

Note: LAC = Latin America/Caribbean; ECA = Europe/Central Asia; EAP = East Asia/Pacific; MENA = Middle East/North Africa; SAS = South Asia; SSA = Sub-Saharan Africa.

Table 4. Privatization Numbers and Proceeds by Region, 1990-2003

Region	No. of Transactions	Proceeds (US$ bn)
Middle East, North Africa	302	18.9
South Asia	399	15.4
East Asia/Pacific	417	65.8
Sub-Saharan Africa	981	11.5
Latin America, Caribbean	1,265	195.1
East & Central Europe, Central Asia	5,634	104.1
Total	**8,998**	**410.8**

Source: Author's compilation from the World Bank privatization database 2005.

Microeconomic Impact

The best-studied aspects of privatization are its effects at the level of the firm. The vast majority of studies report post-privatization increases in profitability, efficiency[9] and returns to shareholders.[10] In their extensive survey, Megginson and Netter (2001) estimate that these positive effects occur in about two-thirds to three-quarters of privatizations assessed, a remarkably high rate of success. With the qualifications discussed below, this finding is robust across regions, countries and economic sectors. The microeconomic studies reveal improved post-privatization performance in both industrialized and developing countries, and in most manufacturing, commercial, industrial and service sectors. For example, an Inter-American Development Bank (IADB) review of privatization in six Latin American countries[11] found an average increase in profits (return on sales) of 29.8 percent in a large sample of privatized firms. Efficiency gains, as measured by output per worker or ratio of costs to sales, increased on average by 67 percent. Output increases averaged 34 percent, "regardless of the indicator used" (IADB 2002, 3).

[9] Usually measured in terms of labor productivity, but sometimes by total factor productivity tests.

[10] What economists call "selection bias" may be at work in these findings. The term has two meaning: First is the possibility that it is not privatization that improves firm performance, it is, rather, that the highest potential firms are selected to be privatized—thus skewing the findings in favor of divestiture. The second possibility is that the analyst consciously or unconsciously chooses to study the better performing privatized firms. This concern rose most acutely in privatization in the transition states. For discussions of selection bias and ways to test for and overcome it, see Marcincein and Van Wijnbergen, 1997; and Frydman et al. 1999.

[11] Argentina, Brazil, Chile, Colombia, Mexico and Peru.

Note that it is not fully understood just why privatization produces, or is associated with, these improvements. Economic theory, either in its neo-classical or amended forms, offers "no clear picture…of a definite advantage of private ownership" (Roland 2004, 21). Analysts point out that the likely sources of the improvements are improved information and incentives for managers, greater access to capital market resources and pressures, increased isolation from political interference, and increased flexibility to deal with labor and other cost concerns. Doubtless, all are, at times, of great importance.

The problem is that privatization is almost never introduced as a stand-alone reform. It is usually part of a package of liberalizing policy changes that increase openness and competition at the same time that private ownership is introduced. This makes it hard to determine the extent to which ownership change in and of itself accounts for the improvements seen; it may be that increased competitive pressures are an equal or better explanation for the altered behavior (see Tandon 1995). Whatever the underlying cause, the fact remains that firm performance most often improves.

Macroeconomic and Welfare Impact

Concerning the fiscal and macroeconomic impacts of privatization, the IMF found that in a set of 18 developing and transition economies[12] privatization proceeds were large, that the net[13] receipts were saved (generally meaning that they were used to retire debt) rather than quickly spent, and that governments' fiscal positions benefited from privatization. Gross budgetary transfers to the firms and sectors undergoing privatization declined, as did general deficits and quasi-fiscal operations. Though they found a "strong correlation….between privatization and growth," (Davis et al. 2000, 2) the authors noted that privatization

[12] Argentina, Bolivia, Cote d'Ivoire, Czech Republic, Egypt, Estonia, Hungary, Kazakhstan, Mexico, Mongolia, Morocco, Mozambique, Peru, Philippines, Russia, Uganda, Ukraine and Vietnam. For additional assessment of the IMF's findings on privatization, see Brune, Garrett, and Kogut 2004.

[13] Net proceeds average about half of gross proceeds, reflecting the high costs of sales; that is, debt and environmental clean ups, generous severance, retraining and sometimes settlement packages, and high fees charged by transaction facilitators and advisors.

> ….is not the suggested cause of the large increases in growth rates (in the sample countries)….Rather, it is likely that privatization is serving as a proxy in these regressions for a range of structural measures that may be characterized as a change in economic regime (Davis et al. 2000, 23).

More simply put, there is an association between privatization and increased growth, but whether—or the extent to which—privatization causes growth is not known. In a similar vein, for transition states the European Bank for Reconstruction and Development (EBRD) detects a strong correlation between the total amount of privatization and the rapidity and strength of the return to growth (EBRD 2004).

Other regional studies and country cases in particular paint a more nuanced picture. For Latin America as a whole, Campos et al. (2003, 165) find that the effects of privatization of infrastructure on regional GDP *per capita* are "…neutral at worst and most probably positive..." However, it may produce a decline in public sector accounts, thus casting doubt on the argument that privatization generates "fiscal space" for selling governments. For example, in Brazil in the 1990s, huge resources were generated by privatizations. Post-sale, firm financial performance improved. But Macedo (2000; 2005) argues that the Brazilian government used the proceeds on current expenditure rather than debt relief, thus increasing the fiscal deficit. It then compounded the problem by adopting high interest rates in a fruitless effort to defend the Brazilian *real*. Macedo concludes that government misused the privatization revenues to soften its public and external debt constraints, thus weakening the economy. A good part of Brazil's nearly $80 billion in privatization inflows in the 1990s "…went down the drain in the disarray of public finances" (Macedo 2000). Knight-John and Athukorala (2005) make a similar argument in the case of Sri Lanka's use of privatization proceeds, though they note that after 1995 the government began using privatization revenues to retire debt rather than add to current consumption.

A number of other studies demonstrate that privatization has put substantial resources in the hands of divesting governments. They conclude that it provides an opportunity for

governments to put their fiscal houses in order, and redirect expenditure from non-productive subsidization to more socially beneficial uses. As noted, advocates speak of the fiscal space that privatization will or should create.

But privatization does not guarantee that the opportunities will be seized, that the funds will be wisely applied. A key question is how governments actually use the generally large, but one-time or short-term gains. The IMF concluded the funds were not generally wasted, but it did not specify the revised allocations of expenditures. McKenzie and Mookherjee (2005, 72) note that government spending on health and education in Mexico increased by 50 percent in the period of peak privatization revenues; that similar social spending in Argentina also increased following privatization (and the reduction of spending on debt servicing); and that Bolivia earmarked a portion of privatization revenues to capitalize a national pension fund and make special payments to all citizens over the age of 65. These are but scattered impressions; the subject requires wider, much more detailed investigation.

Welfare Effects

Improved performance in firms does not sufficiently measure the utility of privatization. A privatized firm may be doing better while the economy is doing worse. This may occur due to the firm's exploitation of a monopoly position, or to government policies, protections, special arrangements or even illegal actions that give the firm an advantage. Its superior performance (and even its greater contribution to government revenues through increased tax payments) might be at the expense of competitors or taxpayers. In short, firm and/or government financial performance might be improved only because of costs imposed elsewhere in the broader economy.

This notion is straight-forward, but determining whether and to what extent there is agreement or deviation between the narrow and broad impacts of a privatization is complex. To address this issue, economists use concepts derived from welfare economics, combined with techniques drawn from social cost-benefit analysis. They ask not simply whether the position

of the firm, the government, or any single actor has improved or worsened due to privatization, but rather: What was the privatization's impact on the economy as a whole; what significant economic variables have changed as a result of the privatization, and only as a result of the privatization? They then ask, do the changes brought about by privatization result in gains or losses for relevant actors in the economy—the divesting government, consumers, workers, the buyers, competitors—and, if so, how are they distributed among them; i.e., who are the winners and the losers from the process? After estimating the total loss or gain, and the distribution of the loss or gain, one can calculate the overall economic impact of a privatization.

The seminal work employing this approach is that of Galal et al. (1994). Later works in this vein include those of Newbery and Pollitt (1997), Jones, Jammal and Gökgür (1998), Domah and Pollitt (2000), and a number of works in progress on African cases by Gökgür, Jammal and Jones (2005).

To answer the question of what changes were brought about by privatization (and, to repeat, only by privatization), all of these works construct a "counterfactual." This is an estimate of what would have happened if privatization had not taken place, and the publicly-owned firm had continued in operation. Analysts readily admit that counterfactual construction is demanding and difficult. Even the most careful estimate of what would likely have happened requires a bit of "crystal ball gazing."[14] For the counterfactual to be transparent and persuasive, the assumptions used in its construction must be plausible; for example, that technology coming on line after the privatization would (or would not) have been adopted by the public firm. Small or seemingly innocuous assumptions can make a large difference in projected outcomes. One is in effect constructing hypothetical history.

[14] The phrase is David Newbery's; other analysts agree: "In a study of this sort, innumerable choices of parameter values and other assumptions are made on the basis of judgments or educated guesses. This obviously leaves a lot of room for subjectivity" (Galal et al. 1994, 536).

Perhaps because of these difficulties, welfare analysis based on elaborate and systematic counterfactuals has been applied in only a limited number of cases. However, note that almost all of the studies carried out as such report substantial aggregate welfare gains from privatization for the economies in question.[15] The same positive conclusion is reached by the larger number of other studies calculating welfare consequences with less elaborate counterfactuals or by totally different methods.[16] Thus, empirical analysts answer "yes" to the question, does privatization contribute positively to the overall economy? How these aggregate gains are distributed among relevant actors and income groups is discussed in Section IV.

III. Caveats and Institutions

In the main and on average, privatization produces positive microeconomic results. But not always. Where and when does privatization *not* work, or work less well? Experience reveals two major caveats, and one corollary. First, privatization is less likely to succeed in low-income countries or in settings where markets are embryonic, due either to their never having been established or having been suppressed; i.e., some post-communist countries.[17] Second, privatization is harder to carry out and is more likely to produce questionable or negative effects in the natural monopoly segments of utilities/infrastructure services and in banks and insurance companies, where some aspects of the firms' functioning require government rule-setting and monitoring to protect consumers and depositors.

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[15] Galal et al. (1994) found substantial welfare increases in 11 of 12 privatizations examined, from Great Britain, Mexico, Malaysia and Chile. Newbery and Pollitt (1997) found the same for the case of Britain's electricity industry, and Domah and Pollitt (2000) confirmed the British results, and expanded them to Wales. Jones, Jammal and Gökgür (1998) found welfare increases from Cote d'Ivoire's privatization program as a whole.

[16] See for example, Arocena (2001, Spain), Barja, Mckenzie and Urquiola (2005, Bolivia), Chisari, Estache and Romero (1999, Argentina), Delfino and Casarin (2001, Argentina), Ennis and Pinto (2005, Argentina), Fischer, Gutierrez, and Serra (2003, Chile), Rodriguez and Rivas (2005, Nicaragua), Galiani et al. (2003, Argentina), McKenzie and Mookherjee (2005, summation), Paredes (2001, Chile), Toba (2003, Philippines); Torero and Pasco-Font (2001, Peru), and Torero, Schroth and Pasco-Font (2005, Peru).

[17] This statement does not contradict the EBRD findings of the positive impact of privatization in the transition region. The transition countries that have done privatization well are those in the western section of the region; i.e., those that have historically been part of capitalist markets and traditions. The farther east one moves in the region, the more difficult and problematic privatization becomes.

The evident corollary is that difficulties are most likely to surface when these two situations are combined; i.e., when privatizing an infrastructure or financial public enterprise in a low-income or post-communist country. Common difficulties are outlined below.

- Private operators and investors often find that records and accounts of the firm, on which they based their offer, are inaccurate or completely false, particularly with regard to the state of assets and the collection of tariffs;
- Some liabilities were not disclosed;
- Government will not or cannot accede to tariff increases called for in a formula agreed to in the contract;
- Local courts will not or cannot assist in enforcing agreements, or assist in maintaining shareholders' rights; or, on the other hand,
- The private provider makes a low bid to get a foot in the door and then, pointing to informational and institutional deficiencies, claims an inability to meet terms, and demands renegotiation of the contract.

Institutional Requirements

The underlying reason for both the sectoral and the geographical problems is the same: for markets to function in an efficient, productive and socially acceptable manner, a set of legal, policy and behavioral underpinnings—referred to as "economic institutions"—must be present and operating. These institutions promote, monitor, and render transparent market operations. They include:

- The definition and protection of property rights;
- Contract enforcement and commercial dispute settlement through credible, predictable, peaceful means (more broadly, court decisions that are timely and based on law, not payments or social precedence);

- Independent, well-staffed agencies to regulate the natural monopoly elements of private utilities (that deliver timely, law-based decisions, predictable and credible for both investors and consumers);
- Functioning bankruptcy/insolvency regimes for firms operating in competitive markets; and, in general,
- A public administration that meets modicum standards of predictability, competence and probity and promotes and enforces rules enhancing competition.

These institutions stabilize and render predictable market operations, thereby lowering transaction costs. Where they are absent or weak, privatization is more likely to result in poor outcomes—particularly in the case of infrastructure/network industries, and particularly with regard to distributional concerns. Thus, the more extensive the institutional underpinnings, the better the privatization results, in terms of both efficiency and equity (e.g., Chile vs. Argentina, Hungary vs. Russia).

The idea that institutions heavily influence economic vitality has rapidly risen to the status of conventional wisdom. The association between the existence and performance of economic institutions and good results from privatization is widely predicated (Stiglitz 1999a; 1999b). Rodrik, Subramanian and Trebbi (2002) go further; they argue that "the quality of institutions 'trumps' everything else" in explaining all economic development outcomes—while admitting that the finding is at such a high level of generality that it provides little specific guidance to policymakers.

The lack of operational precision is the problem: the list of needed institutions is very long, and the concepts very general. Explanations of how these institutions come into being and attain a state of effectiveness are lacking or vague. Research is just beginning on which institutions are crucial in what particular circumstances, or in what sequence they should and can be introduced. While most of these policies/institutions function under at least the partial control of the public sector, and while many donor-supported efforts are underway to create

and strengthen institutions in developing and transition countries,[18] it is, again, unclear as to what governments can do to aid their emergence and enhance their capacity. As Shirley (2003, 1) notes, "…over time the development paradigm has shifted from 'get your prices right' to 'get your institutions right;' the latter instruction has proved as useless as the former."

One cannot simply state that institutions are required, note their presence or absence, and legislate them into existence and competence. This leads to the key dilemma: the countries that stand to benefit most from liberalizing reform and privatization are those with the lowest incomes, the weakest institutions and the worst public sectors. In such settings, the efficiency and financial gains from private operation are potentially very great. At the same time, the risks are high that the reform processes will be mismanaged or captured, and produce suboptimal or errant results.[19]

Up until the late 1990s, the extent to which institutions influenced privatization processes and outcomes was underestimated by most (though not all) of those involved. Placing ownership change before institution-building proved costly in low-income developing states, and even more so in the post-communist transition states. There, speedy privatization had been recommended by the bulk of analysts and insisted upon by the IFIs. The idea was that capitalism required capitalists; many of them, and fast. Ownership change was seen as "…not just a necessary condition of capitalism, but a sufficient one" (Kornai 2000, 5).

This led to the belief that the required legal/institutional frameworks would arise from demand by the new owners of private property. In the transition states, privatization's proponents failed to realize that in the absence of a supporting legal framework, it was more rational in the short run for individual property owners to buy a private police force rather than to band together to help build a law enforcement regime supporting free and fair business

[18] Especially in the creation and reinforcement of legal/judicial systems.

[19] This conclusion is statistical rather than comprehensive; one is talking about tendencies. That is, privatizing an infrastructure monopoly in a low income, institutionally weak country is certainly much more dangerous than doing so in a high income industrialized state, and one can cite a number of cases where such privatizations have gone badly wrong—for recent example, the failed concessions of water companies in Tanzania, Uganda and Mozambique. However, in Tanzania, the quite similar concession of the container terminal is an outstanding success. Low income levels and weak institutions hinder good outcomes, but do not guarantee bad ones.

operations. In a number of low-income countries, infrastructure firms were leased or given in concession to private operators on the assumption that private operation could not help but be superior to public management. But the public sector mechanisms needed (i) to attract a good number of reputable and competent private operators to the bidding process, and (ii) to construct, and especially monitor and enforce their performance contracts, were absent, weak or easily corrupted.

By the end of the 1990s, dissatisfaction grew over corrupt transactions in transition countries (mainly in commercial firms), and ineffective ones in developing countries (centered on infrastructure cases). This led to considerable rethinking about the pace and techniques employed in privatization.[20] Many who had previously been strong supporters of privatization admitted to errors and doubts. The IMF and World Bank, which for a decade had pushed privatization vigorously, became more cautious and less dogmatic about the need for speedy transformation.[21]

The importance of economic institutions, the limitations of ownership change as a stand-alone reform, and the need to modify the excessive optimism of the 1990s regarding privatization, are now well and widely recognized. The proposed solution is "public-private partnerships," but the term is vaguely defined; it is quite unclear as to how workable partnerships will emerge, what they will look like, and how precisely they will differ from what has already been tried. Specificity is lacking on how future reforms will avoid the errors of the past, with regard to both public enterprise reform *and* privatization.

[20] Nellis discusses this rethinking in transition countries (2002) and sub-Saharan Africa (2005a). Note that in the transition region, some analysts justify privatization, warts and all. They argue that the unjust initial distribution of assets was a regrettable but unavoidable price that had to be paid to get these economies into, or back into, the market system; that Russian privatization in particular, though morally deplorable, was better than leaving the firms in state control (Shleifer and Treisman 2000).

[21] World Bank (2005) describes the Bank's shift to a more pragmatic position, away from its 1990s view that the state has little role to play in infrastructure industries.

IV. THE SOCIAL IMPACT OF PRIVATIZATION

Some critics may concede that privatization is of economic benefit, but all question its social utility. They argue that privatization's rewards go to the agile, the rich, the foreign and the corrupt, at the expense of poor and honest nationals. They claim that privatization negatively affects the mass of citizens—that it harms workers because of lost jobs, consumers because of higher prices, and taxpayers in general, because of government under pricing of assets, the collusion of crooked bureaucrats with buyers, or the inability of ill-trained and underpaid public servants to see through the stratagems of clever private investors. The overall claim is that privatization contributes to inequality and poverty.

Certainly, privatization does generally result in job losses: 150,000 in Argentina between 1987 and 1997; roughly 50 percent of all employees in firms privatized in Mexico in the 1990s; a reduction of more than 90,000 from peak employment levels in privatized Brazilian railways alone; the dismissal of 15 percent of the total labor force in Nicaragua due to privatization, to cite just a few Latin American cases. Chong and Lopez-de-Silanes (2002) show that employee numbers are reduced in many firms prior to sale, and that, worldwide, on average, four of five surveyed firms decrease employees further after sale. Surely, this degree of job loss, falling on those whose main source of income is wages, must result in increased poverty and greater income inequality?

The second claim is that privatization and private sector involvement raise the prices for essential goods and services, especially water, sewerage, electricity and transport. There is no dispute that under state ownership many governments set utility prices at less than cost-covering levels. The frequent result was scarcity, rationing, and state firms starved of investment and expansion capital. Thus, price increases are often unavoidable if the firm is to modernize, expand to meet demand, and operate without—or with smaller—subsidies. But critics argue that the size and speed of price adjustments imposed following privatization are often excessive and unjustified, and they decry the supposed harsh impact on low-income consumers. For example, in the short-lived Cochabamba concession in Bolivia, water prices for

poorer consumers rose after privatization by 43 percent on average, and doubled for a small segment of poor consumers (McKenzie and Mookherjee 2005, 49). What is a bearable annoyance for upper income people might be an insurmountable, inequality enhancing financial burden for the poor.

Third, it is evident that some of the investors willing to bid on privatizations in situations of poor information and worse governance are entrepreneurs more of the buccaneer than the Fortune 500 type. And, of course, even the most reputable investors will take all legally available steps to reduce risks, and ensure and maximize profits.

Efforts by investors to influence bid outcomes, obtain costly and sometimes illegal concessions and terms (pre- and post-bid), or collude to reduce the price offered, are often alleged. For a rare example that found its way into print: The *Financial Times* (May 21, 2003, 32) reported an alleged collusion and rigging between two bidders in the 1998 sale of *Electropaulo Metropolitana*, an electricity utility in Sao Paulo, Brazil. The accusation was that, in return for not bidding for the concession, the non-bidder would be given a major contract to build a generation plant for the winning bidder—who, in the absence of a competitor, could and did offer the minimum price for the utility stipulated in the bidding documents. The *FT* cited reports that the winning bidder had come to the final meeting prepared to offer $500 million more than the $1.78 billion bid it eventually submitted; but put in the lower offer at the last second, once it was clear the only competitor was not going to bid. All parties that could be contacted by the *FT* denied any illegality; the Brazilian government was reported to be considering legal action.

Even where no illegalities appear to be involved, it can be difficult for beleaguered civil servants to strike a fair deal with canny and powerful investors. As a Tanzanian official put it, “they (the private bidders) came to negotiate with 10 lawyers from London; we had me.” *Prima facie,* there are reasons to worry about the social impact of these three elements of privatization.

Counterargument

But the latest empirical research dilutes many of the claims that privatization adds to inequality and poverty. Several recent studies examine the effects of privatization on income groups. They move beyond assessments of privatization's impact on a neighborhood, a city, or the employees of a particular firm being privatized. They quantitatively estimate the direct and indirect, short and medium term, distributional effects of ownership change.[22]

For example, McKenzie and Mookherjee (2005) summarize the distributional impact of 10 infrastructure privatizations in Argentina, Bolivia, Mexico and Nicaragua. They calculate that these privatizations:

- Contributed only slightly to rising general unemployment levels (except in Nicaragua, which went through a transition akin to those in formerly communist states);
- Increased access to services, and that this access was disproportionately concentrated in the lower income groups.

Looking specifically at the impact of privatization on income equality and poverty levels, they conclude that:

- "….privatization has a very small effect on inequality" (on average privatization is responsible for increases in Gini coefficients in the four countries of 0.02 or less); and that
- "privatization either reduced poverty or has no effect on it."

[22] They do this by examining differences in household expenditure and consumption for a service—such as water—by income group, before and after privatization. This approach requires survey data from before and after the sale. There are limitations to the approach: Most countries possess only a few surveys; most survey only urban, not rural residents; these surveys usually show amounts spent on a service and not amounts consumed; the questions in and coverage of some surveys vary over time within the same country. There are also problems in calculating price shifts over time; different studies reach different conclusions. The methodological issues, and the techniques devised to overcome shortcomings, are discussed in McKenzie and Mookherjee (2005). The detailed country cases for Argentina, Bolivia and Nicaragua, on which McKenzie and Mookherjee draw, are also found (along with McKenzie and Mookherjee) in Nellis and Birdsall 2005.

The reasons behind these findings are: (i) the direct unemployment effects of privatization are small in relation to the total workforce, and tend to be offset in the medium term by increased job creation produced in part by privatization; and (ii) increased access offsets any negative effects of higher prices.[23] The numbers of workers laid off due to privatization are small, even in Argentina or Mexico, relative to the entire workforce. In the cases reviewed the number of new private sector jobs created by the general reform program, of which privatization was a part, soon exceeded the number dismissed. General and enduring increases in overall unemployment levels in these countries are real and troublesome; but they came some time after privatization and were caused by external shocks, labor market rigidities, and financial indiscipline—not privatization. It has even been argued that, in Latin America privatization may have mitigated unemployment; that is, absent privatization, unemployment levels would be higher (Behrman, Birdsall, and Szekely 2000).

All this calls into question the portrayal of privatization as a prime cause of growing inequality and poverty. But perhaps these findings only apply to Latin America; perhaps the economic environments and privatization processes adopted in other countries and regions have produced more negative results? Given the discussion on institutions above, this seems plausible. The fact is, we do not know for sure, because almost no similar studies have yet been carried out in these other regions.[24] This author's guess is that the distributional impact in other regions would resemble that found in Latin America, except in the countries that were once in the Soviet Union, and perhaps in the institutionally weakest African states.

[23] That is, the positive distributional impact of increased access to privatized utility services far outweighs any negative impact of increased tariffs—where indeed the tariffs did actually increase, which was only half the time in the cases reviewed. Note, however, that a separate study of the impact of private provision of water on access, in Argentina, Bolivia and Brazil, concluded that while access rose under private provision, it increased by just about the same amount in areas that maintained public provision. In addition, this study could not find any differences in increased coverage among the poor between the public and private providers (Clarke, Kosec, and Wallsten 2004).

[24] For three reasons: (i) regions other than LAC have fewer infrastructure privatizations, and those they have are relatively recent; (ii) other regions have fewer and less sophisticated household expenditure and consumption surveys to draw on; their existence is crucial to this form of analysis; and (iii) other regions have less dense networks of local economists at ease with the complex measurement techniques required.

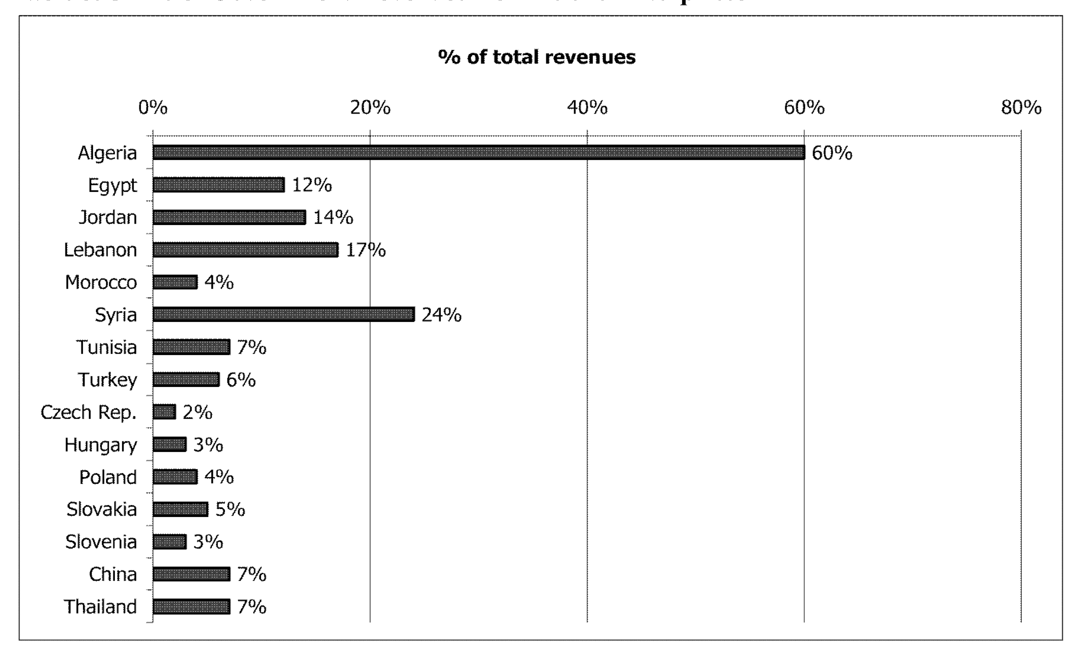
However, even if a dozen studies confirming the McKenzie and Mookherjee conclusions in other regions were to shortly appear, it is unlikely that this would greatly alter the public's negative perception of privatization. The problem is that the argument is not being fought strictly or even mainly on empirical economic and financial grounds; the reasons for the unpopularity of privatization are fundamentally political in nature (see Section VI).

V. Is There Anything Left to Privatize?

Given the extent to which privatization has been advanced by indigenous reformers and the IFIs, one might think the process is substantially completed; that most governments around the world have just about finished privatizing everything they had to sell or transfer. True, in some states the percentage of economic activity accounted for by public enterprises has fallen dramatically; e.g., in Russia and many other post-socialist countries, in Argentina, Mexico, Brazil and a few other Latin American nations, and, more surprisingly, in China. Nonetheless, a very large number of productive entities, including many of the larger and more valuable firms in energy, infrastructure and finance, remain in the hands of the state. The World Bank estimates that, on average, as much as 50 percent of these sectors remain publicly owned and operated in its client countries.

Nowhere is this retention of control by the state more prevalent than in the Middle East and North Africa (MENA). In Algeria, for example, 65 percent of all value-added is still produced by public enterprises, and 90 percent of all banking is state owned and operated. In Algeria, Syria and Iran as well, up to 80 percent of the industrial sector is state owned and operated. Across the region, energy exploration and exploitation firms remain firmly in state hands.

Table 5. Share of Government Revenues from Public Enterprises*



Source: ANIMA- Euromediterranean Network of Investment Promotion Agencies; cited in Kikeri and Kolo 2005.

* Includes mostly revenues from property and tax payments as a percentage of total revenue. Data refer to the most recent year available during the period specified.

Table 5 gives an admittedly partial picture, but nonetheless suggests that the average share of government revenues derived from public enterprise activity is about four times higher in the MENA countries than in other areas. In MENA, public enterprises still account for a higher percentage of GDP than in any other region of the world.

One reason is that the privatization waves that swept the world in the 1990s largely passed the MENA region by, except for Egypt and Morocco, and to a lesser extent Tunisia. In that decade, revenues from privatization were lower in MENA than in any other geographical region (see Table 3). From 2000-03, the last year for which data are available, privatization activity in MENA increased greatly in terms of the value of assets sold (though not in transaction numbers), led by the sales of telecommunications systems in Jordan, Morocco and Saudi Arabia, and several other large sales (the tobacco monopoly in Morocco; cement

companies in a number of countries) that generated significant sums. Nonetheless, MENA[25] has greatly lagged behind the leading privatizing regions in terms of overall number and value of sales (see Table 4).

Within the region, Egypt leads in terms of number of firms sold (39 percent of the regional total), and is second to Morocco in proceeds raised (25 percent of regional total). Since close to half of Morocco's sales proceeds derive from two giant transactions, the Egyptian program can be viewed as the most diversified in the region. As of the end of 2003, Egypt still had not touched "the commanding heights" of the economy such as utilities, but, at the time of this writing, it has scheduled the sale of its large state-owned banks.

Table 6. Privatization in MENA Countries, 1990-2003

Country	No. of Firms Sold	Total Proceeds (US$ m)	Largest Single Sale as % of Total Proceeds
Algeria	4	152	19
Bahrain	1	10	100
Egypt	117	4,688	8
Iran	3	19	37
Jordan	9	937	54
Lebanon	1	122	100
Morocco	80	6,769	31
Oman	8	535	89
Qatar	1	681	100
Saudi Arabia	1	4,080	100
Tunisia	70	800	29
United Arab Emirates	1	190	100
Yemen	6	1	100
Total	**302**	**18,984**	

Source: Author's calculations based on the World Bank privatization database 2005.
Note: See Annex for figures on non-MENA countries.

The 2003 sale of Saudi Arabian telecom alone accounts for over 20 percent of total sales proceeds in the region in the entire period. If one adds this to the two largest sales in Morocco,

[25] Along with sub-Saharan Africa and South Asia.

and one each from Jordan and Oman, the resulting five transactions account for close to half of all the resources raised by the process. Whereas private participation in infrastructure industries (PPI) expanded greatly around the world in the 1990s, MENA countries brought up the rear in terms of number of concluded transactions of this type, and were close to the bottom in terms of investments generated.

Table 7. PPI Projects by Region and Investment Amounts, 1990-2003

Region	Countries	No. of Projects	Investments (US$ bn)
Middle East/ North Africa	14	76	38.3
South Asia	6	198	45.0
Africa	47	224	33.4
Europe/ Central Asia	26	524	118.6
E. Asia/ Pacific	18	701	187.7
Latin America/ Caribbean	28	1008	378.8
Total	**139**	**2,731**	**801.0**

Source: Calculated from the World Bank private participation in infrastructure database 2005.

Note: Investments in PPI far exceed privatization proceeds because, while there is some overlap, a good percentage of the investments are in "greenfield," new entry firms in the infrastructure sectors.

So What?

Does it make any difference that MENA countries have lagged behind the leading privatizers? Given the recent shift away from dogmatic promotion of ownership change, perhaps caution was the correct course of action, particularly regarding infrastructure. It is possible that the slow pace and limited scope of privatization allowed MENA states to avoid the mistakes that followed in the wake of wholesale ownership transformation in the absence of legal safeguards (Russia), or infrastructure privatizations elsewhere in the absence of effective regulatory institutions. Perhaps keeping the largest firms in state hands until the institutional framework is more solid will lead to the attraction of better buyers, higher sales prices, and better, more socially palatable outcomes?

Perhaps—but just as likely not. Many obstacles stand in the way of fulfilling this strategy. First, it will take a long time, during which public enterprise performance may, indeed is likely to, deteriorate further. Second, it will thus be expensive. Most governments are finding it more difficult than ever to provide their infrastructure firms with the capital needed for long-delayed maintenance, much less expansion. Much of the improvement resulting from privatization has come from the ability of new private owners to tap private capital markets. Strained public and/or official funding will not be sufficient to meet repair and expansion needs. Private operators are more able to raise investment capital, both from private markets and from official sources.[26]

Third, some of those advocating slow reform and continued state involvement do so not out of a desire to minimize pain and build institutions, but rather as a pretext to protect their ideological positions, political prerogatives and economic rents. They push for slow privatization; they intend no privatization. This may not be sensible from an economic perspective; unfortunately, it often makes good political sense.

VI. The Political Economy of Privatization: Explaining the "Disconnect"

Privatization usually results in improved performance in the affected firm. Its macroeconomic impact is generally assessed as positive, at the very least in the sense of providing governments with opportunities, and being correlated closely with increased growth and aggregate welfare. Data from the best-studied cases show that privatization's impact on poverty and income distribution is, in many instances, negligible, and far less negative than popular perception would have it.

Why then is the policy so widely, so vehemently, so persistently disliked? As with many economic issues, a good part of the explanation is that privatization's benefits are dispersed, while its costs are concentrated.

[26] That is, as the IFIs revive lending to infrastructure reform, they will be looking for, or actively putting in place, private operators if not owners.

That is, privatization's benefits for consumers at large tend to be dispersed among amorphous, unorganized segments of the public. The average benefits are small for each affected consumer. Mass benefits occur in the medium term, or at least they accrue to a significant size in the medium term.

To illustrate: In several Latin American cases, post-privatization average real electricity tariffs declined by 5-10 percent, and there are numerous cases, worldwide, of even larger reductions in average real telephone bills. In the aggregate, these savings are substantial and worthwhile gains for any economy. And increased disposable income by a few dollars a billing period (along with service quality improvements, lowered pollution, and a number of other social gains that often come in the wake of privatization) is no doubt welcome by the great mass of consumers. But gains of this nature rarely if ever move masses of consumers to mobilize politically in favor of the policy, much less the reforming regime. Moreover, many of the beneficiaries of coverage increases resulting from infrastructure privatization are the poor, who are both less organized and less organizable. In addition, some consumers, particularly poor ones, probably do not associate any gains from reduced tariffs (to the extent they even perceive them)[27] as having anything to do with privatization of the service. The upshot: Modest average price declines thrill economists, but not the broader public.

The costs of privatization, in contrast, are concentrated. They affect a visible, vocal and urbanized few—dismissed workers, represented by powerful public sector unions; bureaucrats in supervisory ministries that lose their authority, perks and perhaps even *raison d'etre;* managers and board members of public enterprises removed pre- or post-sale, middle-and upper-income consumers about to lose a service long-furnished at a subsidized price. Though the sum of their welfare losses may be (presumably often are) much less than the aggregate gain, these actors possess "voice" and access to power; they can and do make their needs and views known.

[27] Sometimes price reductions (where they occur) are not expressed in consumers' bills for a year or two. If inflation has remained at even a moderately high level, the average consumer could end up paying more in current terms, and the gain would only be seen when a constant currency value is used.

They are motivated to do so because the loss for each affected individual is comparatively large and intensely felt, and it occurs in the very short term; indeed, in the case of affected workers, often before the completion of the transaction. Losses of comparatively large magnitude, among stakeholders of this nature, typically result in protest, direct political action, or equally (if not more) effective bureaucratic delay and misdirection. It is easier to mobilize protest against losses and generate sympathy for the losers, than to engender gratitude for gains. And the gratitude created by the awarding of any gain is far less politically potent than the protest generated by the imposition of an equivalent loss.

This situation is hardly unique to privatization. A number of liberal economic policy reforms—reducing barriers to trade, increasing labor market flexibility, reducing or eliminating rent controls, and rationalizing tax regimes are but the first four that come to mind—can be shown to generate medium-term economy-wide benefits. But when they are implemented they impose costs on some previously benefiting segment or segments of society. The affected take steps to protect their interests. They portray the loss as a threat to society, not simply to their or their group's utility: They are taking away our jobs, and you are next; we workers are asked to pay for management's and politicians' mistakes; foreigners are controlling and misusing our most valuable national resources; national security is being weakened, and so on. All this is expected and predictable, the warp and woof of normal political life. The function of the political system is to reconcile the conflicting demands;[28] some manage to do so, many do not, at least, not often or for long.

But privatization is a particularly easy target to hit. The pain that privatization imposes on limited groups arouses sympathy, and is readily described as a cost, or potential cost, to society at large. Pro-privatization arguments are dry, technical and abstract. Foes of liberal reform find

[28] Leroy Jones of Boston University once offered an excellent definition of "political Pareto optimality:" A shift in resources in the system such that one actor is made better off without any other actor *realizing* that someone had been made better off. For a discussion of the techniques used by governments that have succeeded in cutting back on long-established public subsidies and entitlements, see Pierson (1994). Four main tools have been employed: informing the public of the costs of past policies and the costs of inaction; informing the public of the nature and spread of benefits; dialoguing with and compensating the losers, and—in line with political Pareto optimality—"lowering the visibility of costs," or, more bluntly, "obfuscation."

in privatization a simple, visible, comprehensible summation of all they oppose. Privatization has become a lightning rod and handy scapegoat for all discontent related to liberalization and globalization.

Thus, anti-privatization leagues (and forums, workshops, toolkits, strategies, and so on) are numerous and popular, and receive strong support from trade unions. Many journalists, academics and other opinion-makers in developing countries share an anti-market perspective; they often perceive and portray privatization as imposed, unnecessary, unproductive and unfair. While the negative results of other liberal reforms are sometimes too indirect and unclear to spur active opposition, privatization's costs appear evident.

In addition, supporters of privatization have often misplayed their hand. Many governments (and donors) oversimplified the economic situations faced, and vastly oversold privatization as the key to rapid and sustained growth and social progress. For example, Anatoli Chubias famously stated that the Russian privatization voucher would quickly attain the value of a Lada car; most Russians found that their vouchers, and the shares for which they could exchange them, were valueless.[29] Thus, when the rosy financial claims, and growth and job creation predictions were not fulfilled, the backlash was strong. Many governments have been unable to manage the high expectations of consumers and the electorate.

Even in cases where privatization is a clear economic/financial success, and there is no issue of price increases for essential infrastructure services, political problems still arise. For example, in several sub-Saharan African states, privatization of commercial firms has produced generally good results. Most are now making profits; they are providing goods and services of higher quality and in a more reliable manner. Job losses were relatively small, and the privatized firms are paying better salaries to those fortunate enough to have retained their

[29] Similar problems arose in almost all countries that employed vouchers in privatization programs; e.g., the Czech Republic, Slovakia, Romania and Lithuania.

positions.[30] Governments no longer have to subsidize their losses or carry their debts. All should be content—but they are not.

In both Zambia and Tanzania, for example, many of the commercial public enterprises, in banking, mining, brewing and transport, were purchased by South Africans. The nationality of purchasers is an issue in privatizations around the world; every country is concerned with this question, including OECD states. It is a particularly salient issue in Africa, however—especially when the buyers are South Africans, nationals of a country that a decade ago was black Africa's greatest enemy. Allegations abound that these buyers often act in an irresponsible, illegal or inefficient manner. The objections have some basis in fact—for example, the buyer of one Zambian mine fired many workers, despite having promised to retain them all, and then failed to pay the legally required severance awards. While the proven cases of misbehavior are far fewer than the claims, they are the ones that catch the public's eye and memory. These events always count among electorates.[31]

Yet another major political problem is that of post-privatization firm closures. A certain number of mainly commercial (seldom infrastructure) firms fail post-sale. That is, there are cases where no amount of new and clever management, fresh capital, or labor and other cost reductions can save the venture. Demand is overestimated, the availability or cost of capital

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[30] Salaries and general job satisfaction tend to be higher in privatized firms than in public enterprises. Job security tends to be lower. Workers likely to be retained post-sale, or obtain work elsewhere if dismissed, tend to be younger, better educated, and male.

[31] Another example: The non-privatized Tanzanian electricity public enterprise, TANESCO, has long provided a poor quality and inadequate quality of service. Brown- and black-outs are very common, and at present, its debts to government exceed $800 million. After repeated failed attempts in the 1990s to improve performance, liberalize the sector and privatize the firm, the Tanzanian Government, under pressure from donors, decided on the interim solution of a Management Contract. An experienced South African firm won the competition. Under private management since 2002, the technical and financial performance of the firm has improved greatly (though the debt overhang remains to be resolved), in good part because TANESCO has reduced its internal operating costs and is for the first time cutting service to non-payers, including government offices. Tanzanians in and outside TANESCO interviewed in June of 2005, including workers in the firm, acknowledge the performance improvements. Still, there is some bitterness and dismay that a handful of white South African managers have been able to do in three years what Tanzanian managers could not accomplish in 40. The fact that the expatriate managers are very well rewarded for their services (in addition to base pay, they receive a portion of the financial savings attributable to performance improvements) is a compounding matter. The level of public grumbling is such that, despite the much improved electricity situation, the government is under some pressure to terminate the contract and reinstate Tanzanian management.

underestimated, key personnel depart or cannot be found, cost and business forecasts are faulty; new, lower-cost competitors arise, and the upshot is firm failure and closure. No quantitative estimates are available on the number of privatized firms that fail to make it,[32] but it is likely to be as high or higher[33] than the normally prevailing rate of business failure in the private sector in the economy in question.

Bankruptcy is a regrettable but normal aspect of business life. Economists readily justify such failure as part of the "creative destruction" of capitalism. Failure and disappearance of firms are seen as productive, necessary processes that take misapplied resources out of the hands of the less competent or unlucky, and offer them up again, in the hope and expectation that the next user will possess what is needed to put them to more productive and profitable work. In this calculation, society is much better off, in welfare terms, by liquidating a persistent loss-maker rather than endlessly subsidizing it. The economic argument is impeccable.

But as another economist (Oliver Williamson) has said, "politics usually trumps economics." No political system will welcome, and few have been able to manage well, the popular discontent stemming from a wholesale closure of firms and hemorrhage of jobs. A few closures may be tolerated; a flood of shut-downs will almost certainly result in government efforts to try to soften the blow. This is particularly true when alternative jobs are scarce, and even if found, may entail longer hours, less security of tenure, and fewer fringe benefits.[34] So the political economy conundrum of privatization is this: When privatization goes well, it is

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[32] Megginson and Netter (2001) state that privatization improves performance in between two-thirds and three-quarters of cases. Presumably, performance either remains the same or deteriorates in between one-quarter to one-third of privatizations. This provides something of an "upper bound" estimate of the percentage of privatized firms that fail.

[33] Higher because privatized firms often inherit conditions that impede rapid transition to "lean, clean and mean" performance in competitive markets. Many studies from transition countries contrasting the performance of different types of firms rank new entry or "*de novo*" firms as the most productive and dynamic; then privatized companies, and last, state-owned firms. The gap between the *de novo* set and the privatized is often larger than between privatized and state-owned.

[34] The question of what happens to workers laid off because of privatization needs more study. In Mexico and Brazil, follow-up surveys show that about half of persons laid off found other formal sector employment within 12 months of dismissal. In both cases, wages were about the same. In Brazil, the new jobs required longer hours and entailed fewer benefits. In contrast, in Mexico, 45 to 50 percent of those dismissed found jobs in the same sector and obtained about the same level of benefits and health coverage (McKenzie and Mookherjee 2005, 68).

close to invisible and taken for granted; when it goes wrong—as it frequently does for some—few politicians want anything to do with it.[35]

VII. CONCLUSIONS

Privatization is a widely applied economic policy. It has, incontestably, produced substantial economic benefits by raising profitability and efficiency in firms, by providing financial resources to strapped governments, and by signaling to creditors, investors and donors the seriousness and credibility of a government's shift in economic regime.

In developing countries, privatization has most successfully been applied in commercial, industrial, manufacturing and service firms operating in competitive markets. This form of privatization has generally proven its worth: Consumers appreciate improvements in terms of quality and quantity of good or services produced—even when prices increase, which is far from the general case. In most countries, complaints about this sort of privatization have been relatively muted and short-lived. Citizenries may not like the job losses or the foreign ownership of breweries, banks, mines and hotels, but the matter rarely reaches the level of street demonstrations. The more important issue, economically and politically, is that of infrastructure privatization.

On this issue, the first point to note is that privatization has also produced improvements in infrastructure sectors in many developing countries, most often and obviously in telecommunications (where technological change has made competition relatively easy to introduce and maintain, and private provision has become the norm) and transport, less sweepingly but steadily in electricity, and more problematically in water. What is often overlooked is that, even in the more difficult sectors and settings, private involvement in infrastructure generally produces results superior to those previously attained by the public

[35] And those politicians who have stood by privatization until the bitter end—Anatoli Chubias in Russia, Roger Douglas in New Zealand, Carlos Menem in Argentina, for example—have paid a high political price for their tenacity.

provider.[36] For example, a review of seven "private participation in infrastructure" cases in sub-Saharan Africa concluded that none of these privatizations produced levels of service and cost recovery comparable to best practice in industrialized countries. All suffered from financial or political problems (or both). Still, all the results were "better compared to what outcomes would have been without private sector contracts" (Castilla Strategic Advisors 2005, 1). A second set of African case studies, by Gökgür, Jammal and Jones (2005), reaches much the same conclusion. The financial and operational improvements made under private provision need to be better disseminated.

Despite the comparative success, infrastructure privatization remains a problem, especially in low-income countries, and most acutely in the electricity and water and sewerage sectors. There, because of the essential nature of the goods produced, because of the level of decrepitude of the businesses being privatized, because of the unwillingness or inability of governments to impose costs on elites, and because of the relative power of the private investors vis-à-vis the civil servants they deal with before and after the transaction, it has proven hard to construct credible and enduring transactions. A number of renegotiations, non-renewals, and outright cancellations of contracts have occurred (Harris 2003). Because of the problems, it has proven easy to cast privatization—not just in infrastructure but across the board—in the role of a (or even the) social villain; the tool of the rich, the foreign, the corrupt. In sum, privatization has everywhere and inevitably proven to be an intensely political event, even more than most other economic reform measures.

What Next?

Many public policies move in and out of fashion, but few have shifted in pendulum-like manner to the extent of privatization. More than a decade ago, Gomez-Ibañez and Meyer (1993) wrote of the

[36] The most shocking aspect of the cancelled lease contract in urban water in Tanzania, mentioned above, was that this was a rare case where the private operator did worse, by a variety of technical and financial measures, than its public enterprise predecessor. Far more often the problem is that a financially exhausted government allows a private operator to charge a cost-covering tariff, or contracts to allow tariffs to rise in line with input prices, and this at once or eventually provokes a public outcry, protests, and a political crisis.

cyclical process of privatization and nationalization (see also Klein and Roger 1994). The idea is that private provision of utility services eventually, inevitably, leads to conflicts over what price the provider may charge to cover costs, and what is a "reasonable" return on investment. A common response is more and more strenuous government intervention and regulation. This decreases returns and causes the private operators to quit the market, and/or to the government takeover of the service. But this solution too is short-lived. Populist pricing, insufficient investment, and a failure to sustain reform short of ownership change lead to problems of both quantity and quality of service—provoking once more the increasing involvement of the private sector, first as managers and financiers, sometimes as owners of the utility. And the cycle begins anew.

Privatization events roughly approximate this model in many developing countries. Are we then at the stage where a wave of renationalizations might occur? The answer is, no. The past never simply recurs; the next cycle will encounter a changed political-economic landscape. For prime example, the preceding wave of nationalization in developing countries involved many firms producing tradable goods as well as infrastructure services. As noted, few sustained anti-privatization protests have centered on the divestiture of manufacturing, industrial or non-infrastructure services. No leader, either in left-leaning Argentina, Brazil or even Venezuela (or Russia, for a non-Latin example), has yet seriously suggested the renationalization of privatized commercial or industrial concerns (with the possible exception of banks and the energy/petroleum sector). The likelihood is high that all these divestitures will be allowed to stand; the legitimate arena for private action has been expanded.[37]

Utilities, as usual, present a more complex story. First, outside of telecommunications, declining investor interest has made it difficult to launch any new concession, much less outright purchases. Few private operators are presently willing to invest equity and take major and long term risks in emerging market utilities. Investors that remain are looking for management contracts

[37] The test will come when (if) some of these privatized firms fail or otherwise go out of business. Particularly if they are large employers, or the only employment source in a region, governments will be greatly tempted to renationalize them simply to keep them alive and maintain jobs. Indeed, many commercial firms originally became state enterprises, in India, Mexico and elsewhere, because governments would not allow them to disappear the first time they failed.

or carefully hedged leases with most if not all of the commercial risk being borne by governments. Second, a number of governments, shaken—and in a few cases removed from office—by public outcry centering on infrastructure privatizations, have become equally unwilling to undertake such ventures.

However, the underlying factors that led initially to private provision of infrastructure have not disappeared: Relentlessly increasing demand for infrastructure services, decaying networks and poor public enterprise performance, and exhausted state budgets leave many governments with little choice but to continue the search for private infrastructure partners. The constraints are revealed in time of crisis: In many (of the relatively few) instances of cancelled lease and concession contracts, governments have immediately sought to re-bid the contract to another private provider.

The point is that, despite problems and contract woes, most developing states are far more open and more integrated into world capital markets than they were a decade ago. Few will take drastic steps that would further alarm or threaten markets. Most are still financially strapped, and most will require the approval and involvement of the IFIs in further, still badly needed, infrastructure expansion and reform. While the IFIs will be much less insistent on ownership change as a *sine qua non* of infrastructure reform, they will (it is hoped) recall the extent to which their previous infrastructure reform efforts, without private sector involvement, were ineffectual and counterproductive. A major question is whether this time around the governments and IFIs can learn the lessons of the past and jointly devise—and sell to the public—reform mechanisms that give incentives and comfort to reputable private investors, that create and sustain the policy and regulatory institutions that make governments competent and honest partners with the private operators, while at the same time protecting consumers, particularly the most disadvantaged, from abuse.

Annex: Privatization Transactions and Proceeds, 1988-2003, Non-MENA Countries

Country	# Transactions	Proceeds (US $ m)	Lgst. 1 sale as % total proceeds
Albania	55	260	48
Angola	3	6	67
Argentina	171	44,598	35
Armenia	122	302	47
Azerbaijan	42	14	36
Bangladesh	36	72	17
Belarus	68	7	29
Benin	14	55	26
Bolivia	93	1,052	58
Bosnia	8	53	47
Brazil	185	83,523	6
Bulgaria	379	4,175	16
Burkina Faso	9	14	35
Burundi	4	8	50
Cameroon	18	386	18
Chad	1	1	100
Chile	37	3,542	27
China	182	38,936	14
Colombia	37	6,757	32
Rep. of Congo	2	3	67
Costa Rica	6	56	45
Cote d'Ivoire	54	595	32
Croatia	35	3,130	27
Czech Republic	124	15,199	25
Dominican Rep.	4	644	33
Ecuador	11	169	32
El Salvador	7	1,070	28
Eritrea	2	2	100
Estonia	440	994	22
Ethiopia	13	287	60
Fiji	1	2	100
Gabon	3	3	100
Georgia	3	18	58
Ghana	104	954	48
Grenada	2	6	100
Guatemala	5	1,364	51

Privatization Transactions and Proceeds, 1988-2003, Non-MENA Countries (cont.)

Guinea	1	45	100
Guyana	5	67	34
Haiti	1	17	100
Honduras	40	100	15
Hungary	1,022	15,436	8
India	100	11,486	7
Indonesia	29	7,129	24
Iran	3	17	41
Jamaica	47	764	26
Kazakhstan	33	6,977	62
Kenya	100	274	20
Krygyz Rep.	27	138	62
Lao PDR	25	31	32
Latvia	42	1,299	22
Lesotho	8	59	44
Lithuania	122	2,154	24
Macedonia	577	1,015	34
Madagascar	3	58	62
Mali	10	51	37
Mauritania	6	54	89
Mexico	268	34,833	9
Moldova	16	58	43
Mozambique	165	194	35
Nepal	13	17	29
Nicaragua	81	286	40
Niger	1	30	100
Nigeria	83	1,150	45
Pakistan	146	2,975	35
Papua NG	1	224	100
Paraguay	2	42	52
Peru	181	8,503	16
Philippines	101	4,256	12
Poland	523	22,328	19
Romania	1,211	2,815	24
Russia	112	9,814	19
Rwanda	1	0	0
Senegal	9	415	26
Serbia & Mont.	23	2,348	39
Sierra Leone	1	2	100

Privatization Transactions and Proceeds, 1988-2003, Non-MENA Countries (cont.)

Slovak Rep.	379	8,698	31
Slovenia	16	1,189	33
Sri Lanka	104	889	25
Tajikistan	3	2	50
Tanzania	107	351	17
Thailand	23	4,971	13
Togo	12	38	34
Turkey	230	4,906	8
Uganda	73	266	13
Ukraine	34	509	17
Uruguay	12	236	64
Uzbekistan	8	242	88
Venezuela	62	6,073	31
Vietnam	5	8	63
Zambia	86	820	30
Zimbabwe	18	349	27
Countries with zero privatizations according to WB database			
Barbados			
Belize			
Cape Verde			
Cuba			
Djibouti			
Guinea Bissau			
Mauritius			
Sao Tome & P.			
Sudan			
Trinidad & Tobago			

Source: World Bank privatization database, http://rru.worldbank.org/Privatization/

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PART II: DISCUSSION
PRIVATIZATION IN DEVELOPING COUNTRIES: A SUMMARY ASSESSMENT

Participants in the discussion that followed the presentation by John Nellis included Abdel Aziz Hegazy, *Former Prime Minister of Egypt*; Ahmed Abu Shadi, *Director General, Cairo Center for Economic Information*; Aly Lotfy, *Former Prime Minister of Egypt*; Anissa Hassouna, *Assistant General Manager of Research, Misr Iran Development Bank*; Cyrus Sassanpour, *Senior Resident Representative, International Monetary Fund*; Faika El Refaie, *Former Sub-Governor, Central Bank of Egypt*; Fouad Sultan, *Chairman and Managing Director, Al Ahly for Development and Investment*; and Samir Toubar, *Professor of Economics, Zagazig University, and Board Member of the Central Bank of Egypt.* The following is a summary of the discussion.

Moderator: Thank you for an excellent presentation. It showed us that we are not alone in our problems and that we can benefit by studying other countries' experiences in the field of privatization. I wanted to comment on Egypt's privatization program. In 2005, privatization gained momentum which is a step forward in light of the poor performance of state-owned enterprises.

Participant: My question concerns the relationship between privatization and unemployment. You mentioned in your presentation that privatization contributed only slightly to rising unemployment. In Egypt, we have a law that says we cannot fire any worker because of privatization. But some workers choose to leave the firm voluntarily and take compensation. If a worker doesn't want to continue working after the firm is privatized can we consider he/she unemployed?

Speaker: The issue of unemployment is one of the most vexed in the entire privatization agenda. I would say that the three political economy issues of substance in privatization are: 1) its effects on employment, 2) the nationality of purchasers, and 3) the extent to which there is some relationship

between corruption and privatization. These are the topics that make the headlines constantly. As I indicated in the study, the data from Latin America carefully estimate that the impact of privatization on unemployment in Latin America was very slight indeed. But that study might not be terribly convincing to policymakers elsewhere. More interesting, in response to your question, is a discussion I once had with some officials in India. Under the government previous to the one in power today, they had an active privatization program. The man who was second-in-command of the program dealt with labor. He said the government had decided to give extremely generous severance packages in advance of privatization. They did not try to pick the workers that would stay and those that would go; they gave everyone in the company a package that was far superior to what they were legally required to provide. They recognized that this approach was quite expensive, and the International Monetary Fund criticized the program's cost. They stuck to this approach because they'd come to the conclusion that the political benefits outweighed the financial costs. I personally thought the amount of money they spent was excessive; indeed, severance packages in privatization are much larger in India, Sri Lanka, Bangladesh and Pakistan than in other parts of the world. However, officials there argue that this is a minor expense compared to what they expect to gain through liberalization in the medium term.

Participant: I want to ask about privatization's effect on liquidity in the market. Recently we witnessed privatization transactions totaling a few billion pounds, and rather than invite potential real stockholders, many speculators were invited to invest. They're not actually interested in the long-term market, but simply want to gain from the difference in prices at the outset. They don't stay too long, maybe a few weeks. In order to finance their short-term investment some of them borrow money from the banks, sell their gold jewelry, or transfer some other stocks they hold into the new stocks. So liquidity has decreased by a huge amount. The question is what is the impact of this liquidity movement on the economy?

Speaker: There are numerous cases where purchasers buy and then quickly sell shares in firms privatized by a public offering. They expect, usually correctly, that the government will under price shares to ensure that the offering is a success. They anticipate that there will be a quick markup in the first few weeks after privatization; they intend to take a profit and run. Some governments have tried to deal with this by either putting a special tax on the sale of stocks of privatized firms in the first 90 days or first year after purchase, or by establishing incentives for holding on to the shares. Most have simply given up and acknowledged that they have to live with this sort of speculation. The way to solve any resulting liquidity problem is to bring more good assets to the market rather than worry about whether this one particular transaction is going to pull resources away from other areas. I don't think there is a hard and fast rule on this.

Participant: Do you believe that the public sector will be completely out of the market in all countries, including the United States, the United Kingdom and other western countries? Should there not be some criteria for what is to be privatized and what is to be left in the public sector?

I believe that privatization concerns both the private sector and government. I understand that with privatization the volume of government activities should decrease. So unless we rationalize government, privatization can never achieve a lot of the objectives you have outlined. In Egypt, the government now employs 5.5 million civil servants. When we started the liberal policy it was only 1.5 million. This leads to a question I always ask and I have never received an answer until now, neither from the World Bank nor from our local experts. How can we balance the distribution of manpower in Egypt between the public, the private and the government, especially that the unemployment problem in Egypt is increasing all the time?

Speaker: Starting with your last question concerning the issue of public sector rationalization and reform: I previously worked on those matters, and it was because of the inability to resolve them that I shifted to privatization. That is, I worked on public sector reform for some time, and, like you, I found that the solutions proposed were too often of a proverbial nature; they were not based

on scientific analysis; they tended to be *ad hoc* in nature. The analysis was more anthropological than empirical; I did not find it of particularly high quality. Public sector management is still talked about in international donor agencies, but in my view very little of a concrete nature is actually achieved. I am not sure why this is the case.

Now, back to the first question; I hope that I didn't give the impression that public sectors would go out of business. It is true that in the mid-1990s there were a number of "market Stalinists" who believed that the public sector was going to disappear. This is now rarely the case. There is increased recognition of the partnership that must exist between the public and private sectors. Governments have a major role to play; that of providing and sustaining basic economic institutions on which good market operations are based. These institutions are essential to good market performance and good outcomes from privatization, infrastructure privatization in particular. Governments must set policy and provide proper regulation of natural monopolies. There is no danger that the public sector will go out of business in any country.

Participant: Regarding the impact of privatization on efficiency, I believe we need to do more quantitative research in order to identify whether privatization has really contributed to higher efficiency. I question that notion and I feel a lot of work still needs to be done to demonstrate this conclusion.

My second point concerns privatization to the workers of a firm. Selling or giving controlling shares to workers has proven very negative in Egypt because ownership is diffused and management is ineffective. Many problems result and failure is frequent. Now the government is thinking of repurchasing these companies. What are your views on this?

The third point concerns privatization's contribution to the budget. The budget deficit is increasing; I believe privatization proceeds should be split between supporting the budget and financial restructuring for the other companies to be sold. However, privatization has not contributed much to the budget and the amount of money spent on financial restructuring was not recouped by the increase in sale prices. What are your comments on this?

Speaker: Most empirical studies show that privatization increases efficiency. The evidence is as follows: Following privatization, the amount of labor used per unit of output almost always decreases. Increased labor productivity indicates increased efficiency. The second measure is the ratio of total costs to sales—that the amount of output is being produced with lesser inputs, not only of labor but of the other factors of production. The third and best measure is the one that is most rarely applied—that is, total factor productivity. But that is a more difficult measurement. In the cases where it has been applied it has been shown generally to have increased. I think the evidence of increased efficiency is quite strong.

The second question is the impact of privatization to workers. The negative experience in Egypt is mirrored worldwide. Privatization to workers was extensively applied in Eastern Europe in the post-Communist period. Many studies show that firms handed over to workers tend to do worse than firms that are privatized to a concentrated, external owner or group of external owners. Firms with concentrated ownership have better performance in restructuring; that is, turning the firm around and making it competitive. Giving or selling firms to workers has not worked out well.

On the contribution of privatization revenues to the Egyptian budget, I do not know the arrangements in place and cannot speak on that issue. I'll leave it to other members of this group.

Participant: I have two comments on issues raised during your presentation that I think are of great importance to us in Egypt. The first is related to the relationship between privatization and growth, and the second is related to the link between privatization, poverty reduction and improving the quality of life for the poor. Everyone knows that investment is always very sensitive to uncertainty. In spite of the fact that reform in Egypt started even earlier than 1991, the response of the private sector at large as regards to increasing the supply side through investment was very poor. I think that this is related mainly to uncertainty. Privatization is important because it gives a strong signal to the business community about the authorities' determination to move toward a market economy. This did not happen in the past perhaps as strongly as it has happened in the last year. The new reformist government has been extremely successful in sending such types of

signals and this was immediately reflected in the substantial increase in the magnitude of investments by the private sector, domestic and internationally. Uncertainty is always related to how you see the future outlook of the economy and whether the economic policies of the authorities are sound and confidence inspiring. This did not happen in the past and that's why the supply response was extremely low.

Regarding the proceeds of privatization, normally there is a big gap between the haves and the have-nots, especially in transition countries like Egypt. In order to mobilize the support of the public at large you should allow everyone to feel the benefit of the move to a market economy. This has not happened; the proceeds have been used elsewhere instead of improving the safety net required for the poor to improve housing, education and health care. These shortcomings relate to the weakness of the institutional framework, specifically the legal and regulatory frameworks. So these are the basic elements that have affected the supply side from the business sector.

Speaker: I have no specific comment; you made more of a statement than a question.

Participant: I think the problem we have in Egypt is not to make people aware of the problems of the public sector, but rather to inform them of the blessings of privatization. This is a vague process in the eyes of the people. They think it is a money-making process for government, and they don't know anything about the proceeds; are they reinvested in the economy, re-injected in firms, or used to pay debts? The point here is transparency.

What do you think about the timing of privatization? Is it a prerequisite for economic reform, does it go parallel with reform, is it a part of a package? Does one develop a so-called “road map” for the timing and sequence of things that need to be done, and the prerequisites in the economic system to make such a process a success?

Speaker: This is a splendid question. However, I think the term “road map” is best avoided; I would rather speak of a need for a set of practical privatization guidelines. I believe we now have sufficient experience, from a large number of countries, in a large number of sectors, and industries, in different political and administrative circumstances, to propose such guidelines. The first of which comes from transparency. Many people mistrust privatization because they think that someone is being paid off or getting a special deal; that some secret and crooked deal is being cooked. There are a variety of ways to increase transparency and reduce corruption. Just to name a couple of practical measures, in the Bolivian privatization program some years back the minister in charge opened on television all bids for all companies being divested. The public could see who bid what, and who offered the highest sums. A second case was in Slovakia, which, under a previous government, had a very poor reputation with investors and donors. A new government decided to sell a mobile telecommunications license. To build confidence with investors, the government asked Transparency International, the anti-corruption NGO, to publicly supervise the transaction. Transparency International vetted the procedures from start to finish and publicly stated what they thought of them. Their involvement put a seal of approval on the sale. The process garnered an enormous amount of good press, in the *Financial Times* and elsewhere. This was a big boost for Slovakia’s image.

There are other methods now available on how to maximize sale proceeds and organize sales. How to do it is now fairly well known.

Participant: I'd like to comment on linkages between the budget and privatization proceeds. The budget deficit in Egypt is high, nobody will dispute that, but it has not been increasing in terms of nominal GDP—it's been in the range of 9 percent or so. But what is equally worrying is the public debt. It is rising by 6-8 percent of GDP every year. Although it is still sustainable, we are quickly getting close to the limit. It's true that the contribution of privatization to budget financing has been limited for the simple reason that privatization itself has been limited. Not much was generated in the past few years, however this year they have soared.

Privatization proceeds are transferred to the budget, but a qualification is in order. Probably no more than 30-40 percent of actual proceeds that the government has earned from privatization are transferred. Some companies retain some of the proceeds for their own internal restructuring; only the balance is transferred to the budget. The view of the IMF is that for the sake of transparency it would be better to reflect the cost of restructuring in the budget as expenditure. It would surely raise the deficit, but also the amount transferred to the budget. Overall, the process would be much more transparent.

In sum, when we say the proceeds are transferred to the budget, I think we have to be careful about exactly what we mean. Just because proceeds go to the budget does not mean they are financing current expenditure. Privatization means selling a government asset to write down a government liability. The immediate financial impact is that government has to borrow less to finance its budget. This should, in turn, reduce the cost of borrowing in the economy, reduce the pressure on interest rates, and over the medium term, open up some expenditure space because the cost of servicing debt goes down. The ultimate objective is to reduce the cost of borrowing for the government, and increase the social component of expenditure. Privatization should contribute to these objectives,

Speaker: I'm very much in agreement. I would like to add one point. The IMF study cited in my presentation, regarding the fiscal and macroeconomic impact of privatization, surveyed 18 privatizing developing countries. The study concluded that most countries used the proceeds in a wise economic manner, but it also said that few countries earmarked the proceeds for debt relief. If I recall correctly, in all of the countries studied, privatization proceeds went to the budget. It did not seem necessary to compartmentalize the funds by earmarking. It's a question of the government using its proceeds wisely. So I agree that transferring funds to the budget doesn't necessarily mean that they are being wasted on current consumption; it's a matter of government having good expenditure procedures generally.

Participant: I would like to discuss an area that is of particular importance to Egypt—political commitment to privatization. We have just gone through an election in which we have seen that the government was very reluctant to divest political power. Is it possible to have meaningful privatization under a government that isn't committed to divesting economic assets?

Speaker: No. Privatization requires strong political commitment; it is not something that can be done half-heartedly or on the sly. A government cannot pretend that privatization is a purely administrative matter, and expect it to achieve any meaningful objectives.

Prior to this seminar, I had not been in Egypt for quite some time. However, in the early 1990s, I worked here on the privatization program. Many officials we dealt with at the time seemed to want the economic benefits of privatization, but they did not want government to be blamed for any resulting political costs. For example, I recall officials who said, if holding company managers wished to divest some companies in their portfolios that was fine, and it did not require government authority or approval. Lo and behold, no holding company manager wished to divest anything at all. They would have had to bear the blame and the public outcry for anything that went wrong. I concluded that privatization could not be done in this manner. You can't do it on the sly, in the absence of commitment. The experience of many other countries reveals this lesson.

Participant: I'd like to make three points. In developing countries, in poor countries, it's difficult to privatize. That is, it's not as easy to do in sub-Saharan Africa as in the United Kingdom. But the benefits are also larger in poorer countries, so it's a paradox. I remember in the *Welfare Consequences* study you mentioned (of which this participant was one of the authors) the benefits in the cases of the United Kingdom and Chile were relatively modest, and they were much higher in the cases of Malaysia and Mexico. The reason is because state-owned enterprises were already relatively well run in the United Kingdom and Chile. They needed privatization much more urgently in the other two cases. If you go to countries where state-owned enterprises are even worse run than in Malaysia and Mexico then the gains can be even more substantial.

The second point is the effects of privatization on employment/unemployment. This is an issue that has been dealt with very carefully. You have to look at all labor, that is, those who stayed with the firm, those who left, and those who could potentially join the firm. If you don't take all three groups into account you are picking one group and leaving out the rest. There is also another complication that has to do with the counterfactual. If you were to keep the state-owned enterprise the way it is, what would have happened to unemployment and employment? Would you have seen sufficient job expansion? When we took all these issues into account—the counterfactual, the people who stayed with the firm and benefited from the expansion, the additional people that were hired after investment has taken place, and the people who left and received compensation—the bottom line, which was one of the most surprising results of the study of those four countries, is that workers were actually better off in all cases. So focusing on a sub-group can be a big blunder because this is not what employment and unemployment is about, it's about everybody.

The third and last point I want to make is that the benefits from privatization are not automatic. They are endogenous. A government can actually manufacture how much benefits an action like privatization will produce, and who is going to get them. It is not something that happens outside the purview of policymakers. Indeed, policymakers can make the deal very sweet for an entrepreneur by, for example, giving a concession that no imports are going to be made in the cement industry for the next 50 years. Well, the entrepreneur who buys into that deal is going to make a killing, consumers are going to pay more, and the government is going to get more money. By contrast, the government can manufacture the deal in quite different ways, to the benefit of other groups in society. So one cannot talk about the benefits or losses from privatization as if it's outside the control of policymakers. Policymakers can decide and determine the outcome of privatization if they are smart enough.

Moderator: To conclude this discussion, I would like to thank Dr. Nellis for a very illuminating presentation as well as the participants and those who contributed insightful questions and comments.

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Privatization has been an integral part of economic reform in almost all countries and across all sectors over the past 25 years. In this *distinguished lecture*, John Nellis assesses the outcome of privatization to date in terms of its impact on the economy in general and privatized firms in particular. Drawing on the extensive evidence available, he finds that the economic impact of privatization is positive in the majority of cases. However, the distribution of the benefits among different stakeholders has not always been even. For privatization to deliver the most benefits, Dr. Nellis recommends that governments adopt appropriate measures to enhance competition, establish effective regulation of monopolies, conduct the sale process in a transparent manner, and devise reasonable packages to compensate the losers.

This publication is the twenty-fourth in the Distinguished Lecture Series published by the Egyptian Center for Economic Studies